Providence
Independent Investment Advisory

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1. Key Points

- Global growth is set to be at the lowest level since 2009 despite QE
- Central Banks effectiveness at boosting sustainable growth is beginning to be questioned
- Global aggregate debt levels remain at record highs
- Interest rates are therefore likely to remain low for an extended period of time
- Valuations for equities have improved after the recent correction
- A cautious investment stance is still warranted

CONFUSION, CONFIDENCE and CREDIBILITY

It is a **confusing** global economic outlook with investor **confidence** waning as the **credibility** of global central banks is brought into question.

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2. Investment Overview

The global growth picture is anything but certain and markets are reacting accordingly with volatility increasing. There is little confidence in the earnings outlook for companies as global growth falters at the same time the credibility of central bankers is now being questioned - The emperor has no clothes.

After 7 years of intermittent global QE and record low interest rates global growth is stagnant with very little investment growth evident. Asset prices have increased and banks have restored their balance sheets but aggregate global debt remains at record levels and subsequently credit growth remains modest. Outside of Australia, who still has interest rate flexibility, there is little ammunition left for central banks. This is structural and with doubts around Chinese growth and global deflationary trends the thought of a global recession are weighing on markets. "Buying the dips" has been the mantra for the past 35 years, now it's not so certain.

The slowing Chinese economy is weighing on investors' minds. The damage to global investor confidence that the intervention of the Chinese government directed support of the falling stock market cannot be overstated. The booming Chinese stock market was a result of domestic retail investors gearing into equities, pouring an estimated 5.3 trillion yuan (US$ 935bn) in margin debt into the market and taking the margin debt to total market capitalisation ratio to 4.5% (similar to the peak in the US market prior to the GFC). The Policy Makers response was seen as panic and incompetence as they tried to support equity markets rather than allowing market forces to make the adjustment in line with the central banks reform agenda.

As a result, confidence in the overall trajectory of China's economic reforms suffered severe damage and questions were raised around their ability to manage the transition of their economy from investment led to consumer driven. Confidence was shot at which point they withdrew their stimulus, again with little communication to the market. Economic data out of China has since continued to soften specifically, industrial production and imports. We now expect real GDP growth to be closer to 5-6% rather than the 7 % quoted. Deflationary trends along with high debt levels remain a concern.

The US economy continues to grow and we expect its economic performance is likely to surprise to the upside although this is likely to be lagging data. The debate around the first interest rate hike in the US continues to swing from a question of "when" to a question of "if" as expectations shifts further and further into the future. The independence of the Federal Open Market Committee (FOMC) is clearly being questioned by the market and a chicken and the egg scenario has arisen where it appears the market is looking at the FOMC for guidance on the first rate hike and the FOMC is increasingly looking at the market in its decision making process.

To be sure, the decision about US rates has become increasingly important as emerging market corporate debt has risen from 4trn to 18trn over the past decade (source: IMF) with a significant portion being USD denominated. As a result, a rising US interest rate environment and the inevitable strengthening of the USD will increase the debt burden in the emerging markets. It is our contention that should these global factors not be present, a US interest rate rise would likely have already occurred.

The strengthening USD comes at a time where the commodity driven emerging markets are struggling with a weakening economy in their key export destination, being China. This provides an additional headwind to these markets.

In the U.S. Corporate profits remain subdued despite the strengthening economy. There has been little top line revenue growth despite record margins with earnings growth coming mainly from share buybacks this is likely to result in weak capital spending and softer labour demand. Ongoing strength in USD will also likely weigh on US corporate earnings.

There are some tentative signs of improving growth in Europe who were "late comers" to the QE experiment. Interestingly, the growth has shifted to the peripheral countries (notably Spain and Greece) from those considered the core (Germany, Italy and France). Despite the mass stimulus from QE, inflation remains weak with the low oil price a key contributor to the weak readings.

Japan is still struggling with demographic headwinds with growth barely above zero and persistently weak inflation readings despite their own significant Quantitative Easing program still underway. We continue to be impressed with the reformist agenda of Shinzo Abe but expect the results will only be realised over the medium to longer term, in the meantime we need to see results from the fiscal stimulus and monetary easing.

The Australian economy, similarly to the emerging markets and other major commodity producers, have to cope with a significant downturn in revenue from the lower commodity price environment. This not only has a revenue impact for direct commodity producing businesses but has also put a halt to further investment in the sector providing an additional headwind to the domestic economy.

The Australian economy is now at risk of a mild recession (if not already in WA , SA and NT) as it grapples with lower revenue from falling commodity prices, slower population growth, flat wage growth, negative net disposable income and a slowing contribution from record levels of housing construction. The weaker AUD and the increase in business and consumer confidence as a result of the change in Prime Minister will offset some of these issues but it will be a fine balance between positive and negative GDP growth over the coming 12 months.

Overall global growth is set to be at its lowest levels since 2009 at 3.1% according to the IMF despite the “whatever it takes” policies of global central banks. Satyajit Das, a former economist turned consultant to central bankers suggests that low growth is likely to continue given the diminishing economic returns from additional debt:

> "In the 1950's you only needed one or two dollars of debt to create one dollar of GDP. By 2007-8 we needed four dollars of debt to create one dollar of GDP. In China… today you need between six to eight dollars of debt to create one dollar of GDP".

In such an environment corporate profit growth will be difficult to attain and deflationary trends will continue to weigh on investors' minds although official interest rates are likely to remain at extremely low levels. Unfortunately however global aggregate debt levels continue to rise.

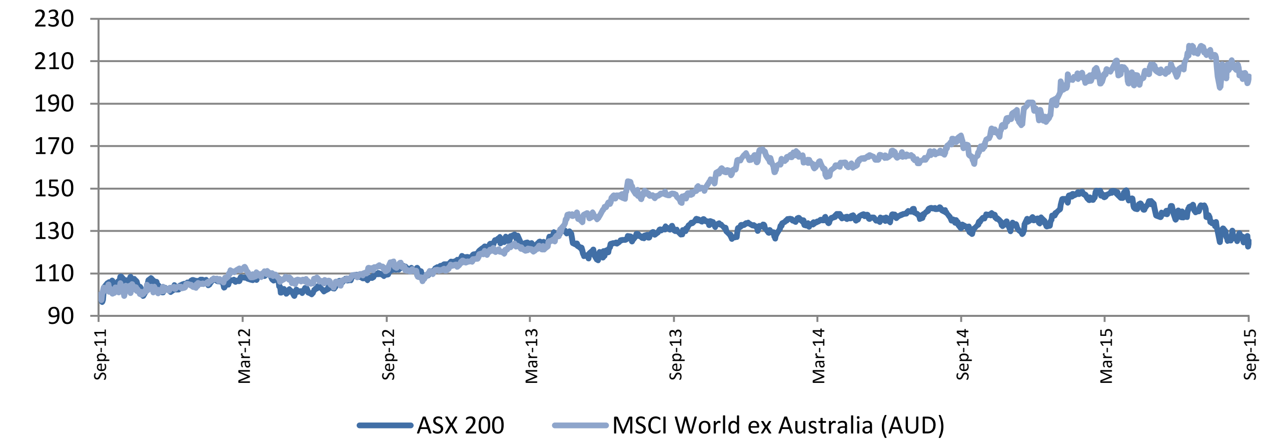
On the positive side valuations in equity markets have improved after recent corrections and dividends remain attractive vs global bonds. Central banks will continue to support asset prices and keep interest rates at ultra-low levels. However, if investors lose faith in central banks' ability to manufacture growth whilst debt levels remain at historical highs a nasty outcome is possible warranting a cautious investment stance.

3. Asset Class Review

3.1 Equities – *Prefer International unhedged*

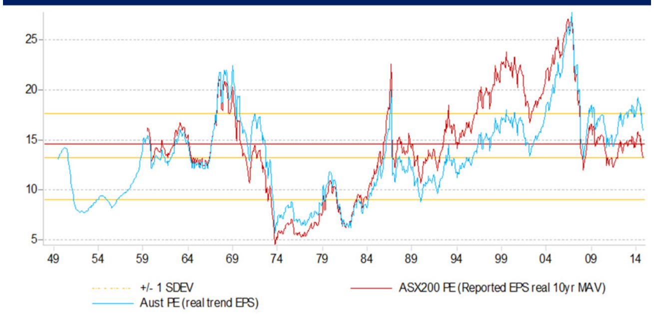
The recent correction in global equity markets has restored some value with Australian equities now showing better relative value to the globe for the first time in a number of years. This is primarily a result of relative underperformance for a number of years (Figure 1) and the fall in resource companies share prices. If we do not head into a global or domestic recession Australian equities may become preferable to international equities on valuation grounds.

Figure 1: ASX 200 has significantly underperformed the MSCI World Ex Aus Index
Source: MSCI, ASX



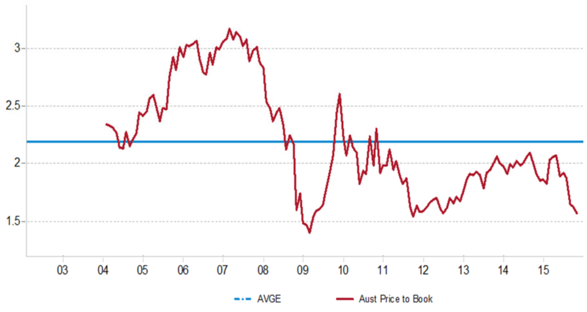
The Australian equity market as most are aware is dominated by two sectors, Banks and Resources. The former is grappling with increased capital requirements, a lack of credit growth outside housing and a bottoming in bad debts. The latter has fallen 59.3% over the past 4.5 years and now only represents 19% of the market from a historical high of 30.7%.

Figure 2: Aust PE (real trend EPS)
Source: IBES, RBA, ABS, using proxy updates



Australian equities are trading around their fair value from a valuation perspective (Figure 2 and 3) however we do not see a significant PE expansion from here with any valuation growth likely to be driven by earnings growth. Given the lack of capital investment (outside of the mining sector) over the past 3 years, we expect earnings growth to be muted.

Figure 3: Australian Price to Book
Source: IBES



At a general level, US equities still appear expensive on long term schiller ratios (Figure 4) although are approaching their long term average price to book ratio (Figure 5). With deflation likely to be an ongoing export from the emerging markets to the US, corporate pricing power is likely to deteriorate and put pressure on revenue. This comes at a time where wage pressures are increasing as the economy reaches full employment.

Figure 4: US PE (real reported & operating 10yr mav EPS)
Source: IBES, Shiller, using proxy updates

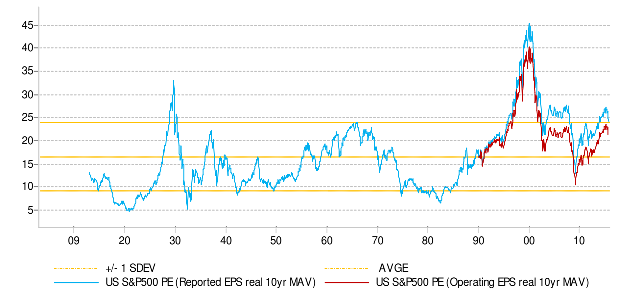


Figure 5: US Price to Book
Source: IBES

As a result, we believe there is likely to be some margin pressure and as such believe a short term recovery is unlikely and an ongoing deterioration in the price to book value may persist.

Emerging market equities have had an annualised return of -3.6% p.a for the past 5 years. Despite this weak price performance, they are still yet to appear fair value in our mind. This is primarily due to the significant decline in Return on Equity over this period and thus justifies a further deterioration in price to book ratios.

Chinese equites after the momentous volatility now are back to reasonable levels although investor confidence has been shot. This will open up attractive opportunities at a stock level which is best left to professional managers.

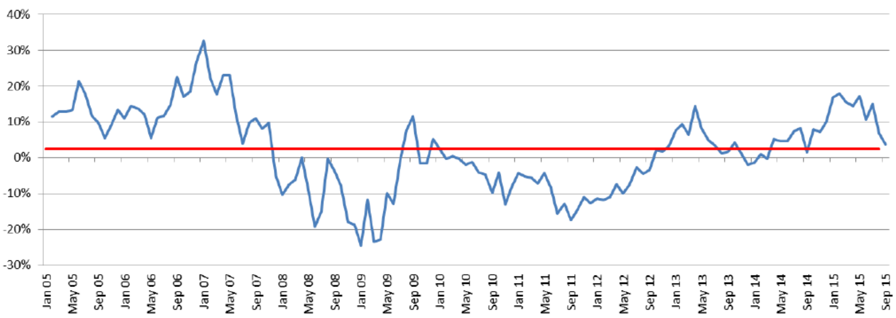
Importantly, within international equities we do not look at indices at an absolute level, rather we search for fund managers who are not constrained by index benchmarks but rather search globally for attractively priced companies in fundamentally strong industries. With that in mind, against global bonds global equities still look attractive.

3.2 Property

We have found it difficult over the past 18 months to find value in direct property. Residential values are inflated after a very strong price appreciation over the past 12 months and offer little value. A-grade commercial property cap rates have been compressed pushing up valuations due to increasing demand from offshore buyers. The chase for yield has also driven industrial and retail cap rates to ultra-low levels partly reflecting lower finding costs. Therefore we have concentrated on value-add direct property plays which have the characteristics of a distressed or poorly managed property. We are also focussed on niche sectors like childcare, medical centres and aged care.

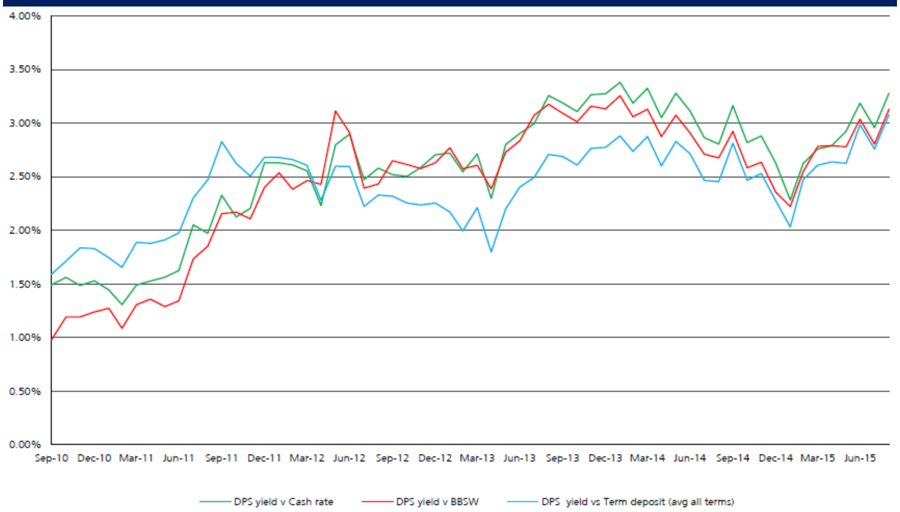
Fundamentally, the listed property sector remains in reasonable shape with valuations lagging gains in the direct property space. Gearing remains low and distributions continue to be funded from funds from operations rather than debt. Current transactional evidence suggests that cap rates could tighten further in the listed sector; however current A-REIT pricing is more acceptable for through the cycle valuations meaning less risk is priced into the listed market.

Figure 6: Price to NAV
Source: SG Hiscock



Overall, the price to NAV across our preferred investment manager's portfolio (SG Hiscock & Co) suggests fair value (Figure 6), however the distribution yields vs cash and term deposits is very high (Figure 7) suggesting further capital appreciation is possible.

Figure 7: A-REIT Yield Vs Cash rate, BBSW and TD's
Source: SG Hiscock



3.3 Fixed Income

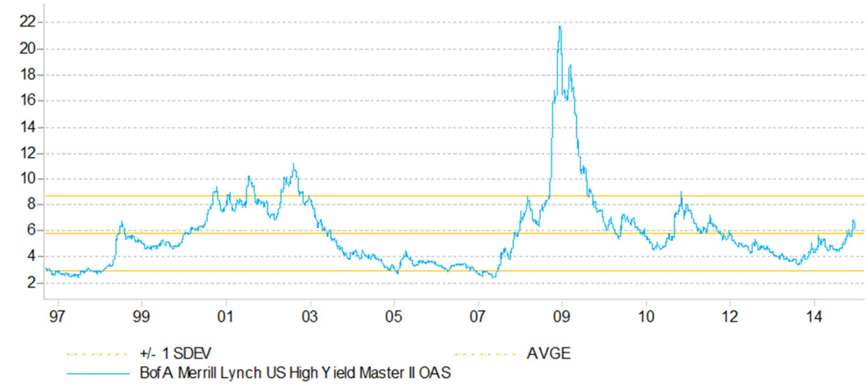
We believe credit markets are likely to be the catalyst for the next market disruption.

As previously mentioned global aggregate debt is at record levels as is emerging markets corporate debt. This is at the same time as investment structures such as ETFs (listed index funds) have exploded and increased bank capital ratios has resulted in a reduction in liquidity. Should there be a sudden increase in risk aversion, the daily liquidity available in ETF's may not match the limited liquidity available in the underlying securities held in the ETF. This may result in a sudden widening in credit spreads (higher interest rate lower price vs treasuries) and as a result potential for significant capital loss. With Investment Banks no longer providing liquidity, we question who the buyer of last resort will be. It can't be ruled out that Central Banks will again need to step up to the plate and support distressed debt.

We are also seeing a widening in credit spreads in high-yield corporate debt as the slower global growth picture is weighing on investor concerns regarding higher default rates (Figure 8).

Similarly to International Equities, we do not invest broadly in the fixed income space preferring to use managers that are index unaware and focused on investment grade securities.

Figure 8: US High Yield spreads
Source: St Louis Fed, BoA



3.4 Alternatives

Alternatives are playing a larger part in our portfolios for clients as we endeavour to protect portfolios from heightened volatility. We have a preference for absolute return, long/ short and those funds that can go long volatility.

Commodities appear to have stabilised, although at significantly lower levels. Low prices are likely to remain for a prolonged period as low interest rates have allowed high cost producers to stay in business for longer than they historically would, keeping many markets in oversupply.

The oil and gas sector is beginning to see a supply side response with the US oil rig count down to its lowest level since June 2010 suggesting an easing of future US supply. Unfortunately, the Organization of the Petroleum Exporting Countries (OPEC) continues to increase production and fill the supply space left by the reduced US rig count.

4. Conclusion

4.1 Opportunities

- Limited
- Select alternative funds that can exploit increased volatility
- Value add and/or opportunistic direct property investments

4.2 Risks

- A reversal of growth in the US economy
- Market dislocation regarding liquidity in high-yield corporate debt market
- A sharp slowdown in the Australian economy
- A sharper decline in Chinese growth
- Emerging Market debt crisis
- Global growth rebounds, stronger than anticipated driven by further central bank support and the lower oil price

4.3 Implications

- Our current investment stance remains "Protective and Cautious"
- We are retaining above strategic benchmark weightings to cash and alternative assets to dampen heightened volatility
- We remain underweight the AUD for any international growth assets

Providence Investment Committee

Steven Crane
Steven has over forty years of investment experience having started in financial markets in the early 1970's. He has held such positions as Senior Portfolio Manager and member of the Asset Allocation Committee at AMP. For seven years he was the Chief Executive of ABN Amro. His current Directorships include among others: Chair of NIB Holdings limited, APA Group, Bank of Queensland and Transfield Services.

Chris Grubb
Chris has held senior Fund Management and Broking positions within the Jardine Fleming Group in Japan, Hong Kong and Singapore. He was also a Director of Jardine Fleming Ord Minnett and Chairman of Investor's Mutual and Investor Web and is currently a Director of several Asian focussed investment funds. He also Chairs Boardroom Australia and is a Director of Boardroom Limited in Singapore. Chris also acts an Executive Coach.

Stephen Roberts
Stephen has over forty years of experience as an economist and financial markets strategist in banking, broking, and funds management. He has worked as Chief Economist with Equitilink and UBS. He worked on the Secretariat of the Australian Financial System Inquiry (Campbell Committee) in 1980, helping draft recommendations that led to the deregulation of the Australian financial system. He is an honours graduate in Monetary Economics from the London School of Economics.

Peter Hooker
Peter has held such positions as an Industrial Analyst at BZW Australia (now ABN Amro), Director reporting to Head of Research, was on the Equities Executive Committee, and Director and Head of Industrial Research. He has a B.Sc. in Chemistry, B.E. in Chemical and Materials Engineering, and Graduate Diploma in Finance and Investment. He has over 25 years of experience in investment markets.

Jonathan Pain
Jonathan has thirty years of international investment experience. He has held such positions as Chief Investment Strategist of HFA Asset Management, Chief Investment Officer of Rothschild Australia Asset Management, Head of Investments at Gulf International Bank in Bahrain, and Chair of the International Asset Allocation Committee at Paribas Asset Management in London. He holds a joint honours degree in Economics and Politics from Keele University, and a Masters degree in the Economics of Finance and Investment from Exeter University.

Ian Wenham
Ian has over thirty years of experience in equity research, investment strategy, and portfolio management. He has held such positions as Equity Analyst with Meares and Philips, Research Director of BZW Australia: covering equity strategy and industrial research. He was also Regional Research Director with BZW Asia, and Director of Asian Research at Lehman Brothers Asia: where he chaired the Investment Policy Committee and was the firm's supervisory Analyst for the Asia Pacific Region. He has also managed the strategic global equity investments for the Lowy Family Private Fund. He currently heads his own investment firm.

Richard Nicholas
Richard has over thirty years of experience in private client portfolio management in London, Hong Kong, and Australia. Richard started his career with Deloittes in London, before cutting his investment teeth with The Rothschild family. He was the founding research director at S&P Fund Research UK, and Investment Director at Hill Samuel Pacific in Hong Kong. He has also held senior positions with Hambros Pacific in Hong Kong, Alliance Capital in Asia, and ANZ Private Bank. He is currently director at Peak Investment Partners.

David Croll
David has over twenty years experience in stock broking and funds management. He has held such positions as a dealer on the options trading floor, the manager of the branch office network for stockbroker Rivkin Croll Smith: based in Melbourne. Since 1998 he has managing several private companies involved in options trading and investment in listed and unlisted equities. He is currently the Managing Director of Noontide Investments Ltd. He has a Bachelor of Arts majoring in Politics from Macquarie University.

Grant Patterson
Grant has over thirty years of experience in equity markets. Prior to forming Providence he was a Director of ABN Amro, and Head of Retail Broking. He has also held other senior positions such as Senior Institutional Dealer, Head of the Sydney Institutional Dealing Desk, and also Head of Corporate Liaison.

Michael Ogg
Michael has over twenty years of experience in investments, starting his career at JPMorgan Investment Management in London in the early 90's. In Australia, Michael worked for AMP Asset Management holding senior roles in institutional equities, and for Deutsche Bank as a Client Advisor in Private Banking. Michael has an MA(Honours) Economics from Aberdeen University.

Stephen Christie
Steve has over 20 years of investment and finance experience, including as Director and Head of Private Wealth for Ord Minnett, Chairman of the Ord Minnett Investment Committee and Head of Asset Allocation for Goldman Sachs JBWere Private Wealth Management. Steve holds a PhD in Applied Finance, is an Honorary Fellow at Macquarie University, an Adjunct Professor at Notre Dame University Sydney and a Trustee Director of major industry super fund QSuper.

James Smith
James has over twenty years of investment market experience (cash equities). Prior to joining Providence, he held the position of Deputy Head of Domestic Sales at CIMB Securities (Australia) and was a member of the CIMB Equities (Australia) Management Committee. He has also held positions as Director - Sales at RBS, ABN AMRO and Sales at Deutsche Bank. James was responsible for Melbourne Sales/Account management in his previous roles over the last decade and in the last two years, was also responsible for New Zealand.

Glossary of Terms

Alternative Assets	An alternative asset is a newer type of asset that has not been traditionally considered part of an investment portfolio.
A-REIT	Australian Real Estate Investment Trusts. Listed property trusts.
AUD	Australian Dollar.
Buying the dips	The process of buying assets when prices reduce with the view that they will be higher over the medium to long term.
Cap Rate	The ratio between net operating income and the capital cost/market value of the asset.
Credit Spread	The margin paid over the risk-free rate (government bonds).
Deflation	When the inflation rate is below 0 and the general price level of goods and services decreases.
ETF	Exchange traded fund.
Federal Open Market Committee (FOMC)	The branch of the Unitde States Federal Reserve that determines the course of monetary policy.
Funds from Operations	The cash flows generated from only the operations of the business.
GDP	Gross Domestic Product - a measure of an economy's total output.
High-Yield corporate debt	Debt issued by a corporation that has a credit rating that is below investment grade.
Margin Debt	Borrowed money used primarily to invest in shares.
Net Asset Value (NAV)	The value of an entity's assets less the value of its liabilities.
Non-Correlated	An asset class that does not move in a similar direction to another asset class.
PE Ratio	Price Earnings ratio - the share price divided by the earnings per share of the company.
Quantitative Easing (QE)	The creation of new money used by Central Banks to buy financial assets.
S&P	Standard and Poors 500 index - an index of the top 500 companies listed in the US.
Unhedged	In the context of international investments, having full exposure to the movement in the local currencies.
USD	US (United States) dollar.
Volatility	A measure of the variation in prices of an asset class.
Yield Spread	The difference between the yield of a security and the risk free rate (government bonds).